SIA

Foreign Activity

An Analysis of Foreign Participation in the U.S. Securities Markets
Produced by the SIA Research Department

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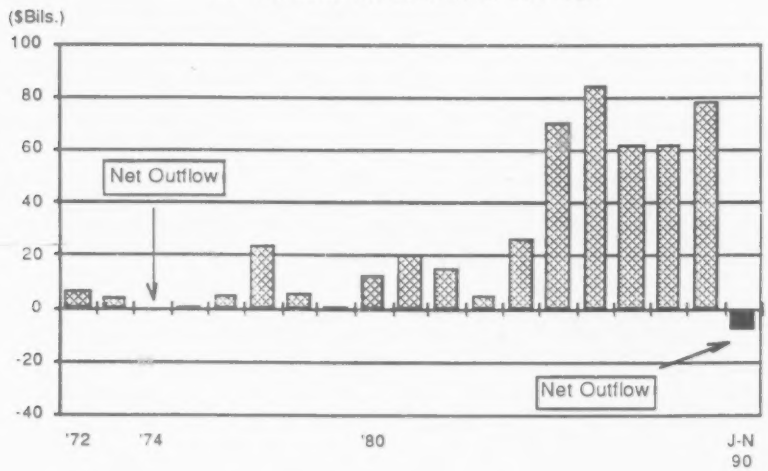
Capital Punishment

Portfolio flows in October and November 1990 followed a pattern similar to that of preceding months. Foreign private investors continued their flight from U.S. equities and Treasuries, while nibbling at government agency securities and corporate bonds. Foreign central banks continued to support the dollar with Treasury purchases. On the other hand, U.S. investors added to their record foreign securities acquisitions, with net purchases of foreign bonds more than offsetting net sales of foreign equities.

Net Portfolio Investment In The U.S.



The consonance of record U.S. portfolio outflows and the substantial reduction in foreign inflows in 1990 may result in negative portfolio flows (foreign inflows minus U.S. outflows) for the first time since 1974. That is, U.S. portfolio investment in foreign markets will exceed foreign portfolio investment in the U.S. market. This trend, in large part driven by the intensified worldwide competition for capital which the U.S. now faces from European and Asian

countries, may be the harbinger of a fundamental change. Indeed, the U.S. investor's strategy of diversification is now being facilitated by SEC rulings (144a, multijurisdictional proposals, etc.) that expand access to foreign securities. That is, the U.S. will face even stiffer competition for its own capital. The 1980s, a decade marred by conflicts over large *trade* imbalances, may give way to increased friction due to the competition for limited *capital* in the 1990s.

Foreign investors, still stung by the events of August, a declining U.S. equity market and a weakening dollar, continued to bail out of the U.S. equity markets in October and November. Moreover, their pace accelerated to net sales of $4.6 billion; the 1990 year-to-date total now stands at $14 billion. While information on individual countries is not yet available, data from the Bank of Japan suggests the Japanese contributed to the sell off. Japanese investors have made net sales of foreign equities in four consecutive months, August through November, confirming a Japanese pull-back from equity markets worldwide, not just the U.S.

It was not only U.S. equity markets that foreign investors abandoned during January through November. Net sales of U.S. Treasuries by private foreign investors, at $2.9 billion, are on their way to the lowest yearly level in more than a decade. Acquisitions of corporate debt totalling $11.7 billion, through November, are headed for a seven-year low. And, the $5.5 billion committed to U.S. agency bonds represents a three-year low. At a time when conventional thinking was for a lower interest rate environment, it is striking that foreign investors should reduce their purchases of U.S. fixed income instruments so substantially. The continued downward trend of the U.S. dollar, with tacit approval by most central banks, has no doubt played a large role in determining this investment posture. A declining dollar makes the price of U.S. assets attractive, but the belief that the value of these assets will continue to decline in dollar terms seems to have been an important factor in foreign investors' hesitance to purchase these securities.

Capital Punishment
($Bils.)

	Jan. 90 - Nov. 90	*Jan. 89 - Nov. 89*	*Net Change*
Equities	(14.0)	11.2	(25.2)
Treasuries	13.3	53.5	(40.2)
-Private	*(2.9)*	*27.8*	*(30.7)*
-Public	*16.2*	*25.7*	*(9.5)*
Corp. Bonds	11.7	16.1	(4.4)
Agencies	5.5	13.5	(8.0)
Total	$16.5	$94.2	($77.7)

What does all this translate to? For one, private foreign capital flows into the U.S. will ebb to the lowest level in more than a decade. All things constant, this means U.S. interest rates will be higher or, at least, higher than would otherwise be the case given past levels of foreign investment. And, with domestic saving showing no signs of inching up from its current anemic 3.5%-4.0%, the U.S. must attract foreign capital.

More ominously, with the U.S. federal and state deficits projected to increase in the coming years, the competition will increase between the public and private sectors for a reduced level of domestic funds. The U.S. will have to tap into a declining global savings pool to keep interest rates from rising and to meet its capital needs.

U.S. Investment Overseas

U.S. investors made net sales of almost $900 million of foreign equities in October through November, reducing 1990's year-to-date total to $6.6 billion. Despite this reduction, U.S. net purchases of foreign equities from January 1989 to November 1990 exceeded the total of all years from 1980 through 1988. During the same period, however, U.S. investors added an additional $2.7 billion of foreign fixed income instruments. Acquisitions of foreign bonds now total over $18 billion.

Foreign bond purchases were fueled by economic forces which have been in place nearly the entire year: yields abroad higher than those at home along with strengthening foreign currencies relative to the dollar. On the equity side, we believe U.S. investors sold off foreign equities to take advantage of rallies in the U.S. equity markets in November.

To date, U.S. investors have now committed nearly $25 billion to foreign markets, well above any prior full-year total. With foreign investors commiting just about $17 billion to the U.S. market, 1990 net portfolio outflows may well turn negative for the first time since 1974.

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